BULLSEYE *Highlights*

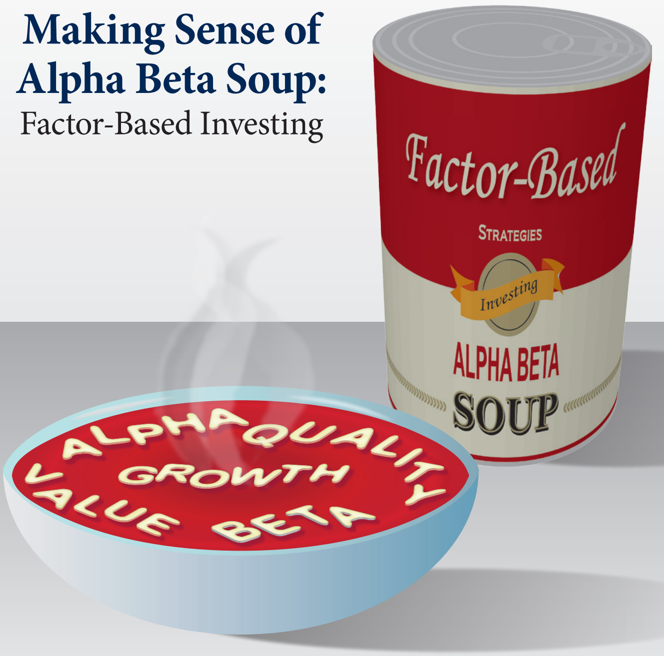
Alpha Beta Soup

The financial services industry likes to throw around technical terms like alpha and beta, yet many people don't know what either of those terms mean. Beta refers to the generic performance of an asset class, such as stocks or bonds. Alpha is the difference in performance, above or below, the generic beta returns of an asset class. For example, a portfolio manager who outperforms a basic stock market benchmark, such as the S&P 500 index, is said to be providing positive alpha.

Many managers claim to generate alpha by outperforming the market, but they typically only do so for a short period under specific circumstances. There is a very small list of portfolio managers who became famous for beating the market for a sustained period of time. Eventually the winning streaks end, but the debate continues—which is better, active managers seeking alpha or the generic returns provided by passive beta? Perhaps the answer lies somewhere in between alpha and beta.

There is a category between active and passive investing that some have deemed "smart beta." The term sounds like an oxymoron, or a contradiction in terms like jumbo shrimp or virtual reality. But smart beta actually makes sense. If beta represents generic stock market performance, then smart beta implies a logical attempt to improve upon the performance through an improved methodology. In other words, smart beta simply argues that there should be some level of discretion or screening applied to a basket of securities.

Making Sense of Alpha Beta Soup:
Factor-Based Investing



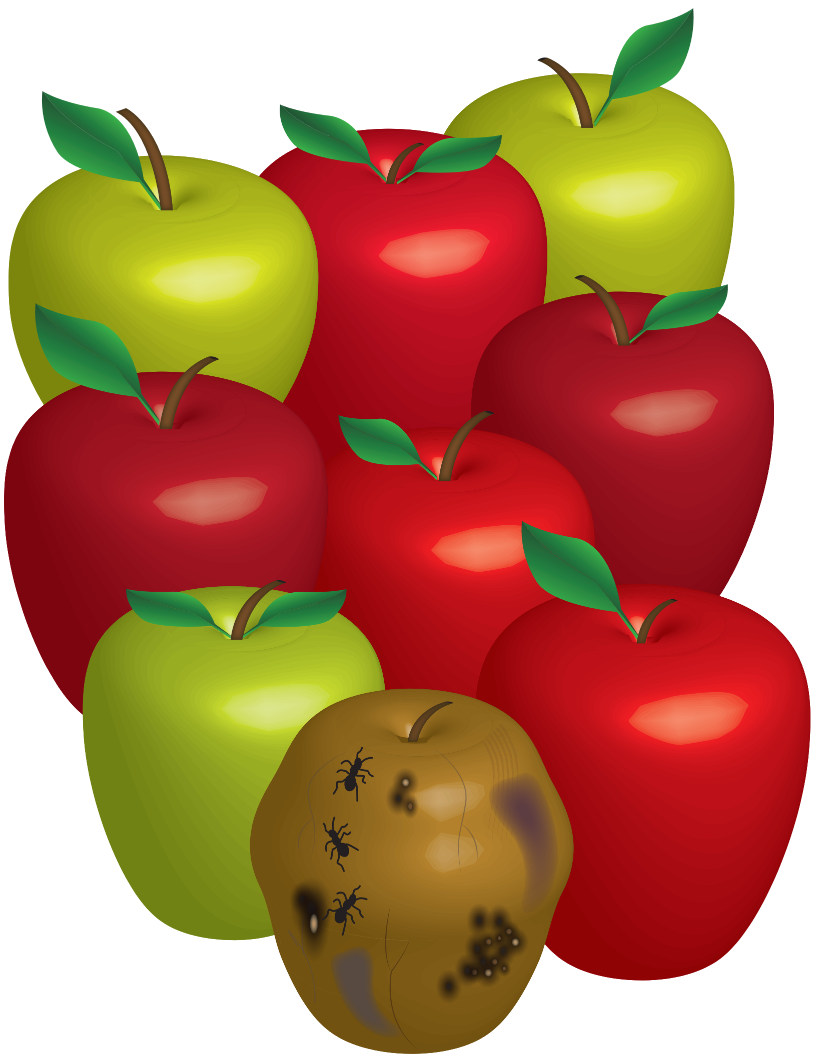
Some investors may favor stocks that are going up the fastest in a bull market, while others may prefer stocks that have fallen the least in a bear market. Some investors prefer stable stocks that pay dividends, while others would prefer companies to reinvest all of their earnings for future growth. All of these factors have merit, depending on the investor's objective. This is where smart beta should be described more accurately as factor-based investing.

There are many different investment factors that vary according to the asset class. In the case of stocks, several factors can be considered such as momentum, company size (market cap), growth, value, volatility, yield, market correlation, and others. On an individual basis, any of these factors can provide certain characteristics that may appeal to an investor. But for many investors, knowing which factors to apply, and when to apply them, is the challenge.

Combining multiple investment factors may be a "smarter" approach to smart beta. For investors seeking stock exposure, without a specific need for any single factor, blending investment factors could make sense. When identifying drivers of long-term stock returns, two factors with a lot of academic support for outperformance are value and momentum (Reference: Fama-French Research, University of Chicago Booth School of Business). Value strategies attempt to identify stocks that seem underpriced relative to their actual financial characteristics. Whereas, momentum strategies try to identify stocks exhibiting the strongest positive price movement with little regard to company valuations. It's easy to understand why these two factors may complement one another. One approach tries to find diamonds in the rough while the other focuses on the high fliers.

Of course there is also the question of quality. Value factors have an element of quality screening, but may have difficulty in determining undervalued stocks from stocks that are low for reasons other than the balance sheet. Momentum factors are somewhat quality agnostic in that they have little regard for the quality of a company, favoring the stock's price movement instead. Again, this explains why these two factors complement one another. But perhaps an even "smarter beta" approach would be to apply a quality screen to the entire universe of stocks while also assessing the value and momentum characteristics.

Quality can be subjective and determining a good company from a great one can be difficult—but identifying the bad ones may be easier. As an analogy, the illustration to the right shows several apples. It would be hard to say which of the apples would make the best pie. Many of the apples have similar traits such a rich color, smooth texture and a bright shine. But before selecting the ones to use in a pie, it would at least make sense to throw out the bad ones. There is no guarantee that the remaining apples will always give the best result, but having basic quality standards is at least a logical starting point.



A similar philosophy can be used for stock selection. Quality stocks tend to have certain traits in common, such as earnings consistency and a good track record of dividend payments. Of course there is no way to tell how well a seemingly good company's stock will perform, but looking for an indication of quality and corporate stability may provide some initial benefit.

If single factor strategies are called smart beta, then perhaps combining multiple factors with a quality screen may be considered smarter beta? A blended approach may lead to the exclusion of the deepest value stocks or some of the fastest moving momentum stocks, but it may also help to avoid a few bad apples along the way.